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THE OUTLOOK

Developed Economies' Stock Gains Pale Beside Emerging Markets' GDP Boom

Divergent performances between advanced and developing worlds puzzle observers—and are unlikely to persist

One example of the growth-market disconnect: Over the last decade, China's economy has more than doubled in size while its market has declined 35%. PHOTO: GREG BAKER/AGENCE FRANCE-PRESSE/GETTY IMAGES

By Josh Zumbrun

Updated Nov. 19, 2017 11:03 a.m. ET

There's something about economic growth and stock markets, across the developed and emerging world, that doesn't add up.

For most of the past decade, the stock markets of developed countries have powered higher even as their economies struggled with sluggish growth.

By contrast, emerging-market economies have grown dramatically but their stock markets have been dismal.

"It's difficult to imagine a very large and persistent disconnect between equity markets and the real economy continuing indefinitely," said Eswar Prasad, a senior fellow at the Brookings Institution.

To contemplate the extent of this disconnect, Mr. Prasad and his colleague Karim Foda of the Brookings Institution's Global Economy and Development program compared the growth and market performance of the major advanced economies with the performance of the largest emerging markets.

Think of it as the major G-7 economies (U.S., U.K., Canada, Japan, Germany, Italy and France) vs. the BRICs (Brazil, Russia, India and China).

U.S. stocks have climbed 76% over the past decade, outperforming India's market by more than 10 percentage points, the Brookings program calculated. Over that same period,

Over the last decade, China's economy has more than doubled in size while its market has declined 35%.

Not all emerging markets have posted such rapid growth. Russia's economy, for example, has grown just 6.5%, barely faster than Japan. But despite posting slightly better growth, Russia's markets are down 50% while Japan's are up by 46%.

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This observation is true whether focused on the biggest emerging markets, or on all emerging markets collectively. Over the past decade, emerging-market economies have nearly doubled in size, growing at an annualized rate of 6.6%, according to data from the International Monetary Fund.

The MSCI Emerging Market stock index has climbed at an annualized rate of just 0.6% over that same decade.

Individual markets and economies have their stories. China's economy has been slowing, a disappointment to some investors. Brazil and Russia had recessions driven by a drop in commodity prices. On the other hand, developed countries have held interest rates near zero and their central banks have flooded their economies with money to spur growth.

Generally speaking, the developed countries have aging demographics and slow productivity growth, while the emerging world has younger populations and can post faster productivity growth simply by copying wealthier countries.

Some of the disconnect is likely natural.

"Emerging-market equities rarely outpace developed-market equities to the extent one might expect when looking at the markedly superior economic growth rate among emerging economies," said Eric Lascelles, chief economist of RBC Global Asset Management.

Mr. Lascelles sees a handful of reasons a sizable gap could persist.

First, emerging markets, in general, have more meddlesome governments and worse corporate governance, he said, which could result in less of their economic growth benefiting investors in those economies. Some investors may avoid such markets, fearing a lack of transparency or weak rule of law in disputes could fail to protect their investments.

Secondly, the stock markets in the major developed economies are full of companies that operate globally, and thus can still benefit substantially from emerging-market growth. The markets in emerging companies "are vulnerable to the opposite effect," he said, with foreign earnings that grow less quickly than earnings in their own economy.

Stock markets can run for years—perhaps very many years—disconnected from economic fundamentals. Companies can borrow at low rates to buy back shares, they could get tax cuts that juice profits, they could improve their management, and so forth. But ultimately, the overall profitability of equity markets must have some tie to real economic growth. There must be more real income, somewhere in the economy, for customers to buy products.

The difference in economic growth is expected to continue. Over the next five years, emerging-market economies are forecast to grow an additional 44% vs. just under 20% for advanced

G-7 economies in overall size.

Broadly speaking, there are four ways the current paradox could be resolved.

Developed economies could accelerate much more than anyone expects, helping to justify their buoyant markets. Or developed markets could come down, better aligning with their growth. Emerging markets could also slow more than anyone currently expects, so their stock valuations look more justified. Or emerging-market stocks could boom, better aligning with their generally robust growth.

Some combination of all four things could happen. The only thing that looks unlikely is for the current dynamic to continue indefinitely.

"Things that cannot be sustained will eventually end," Mr. Prasad said, "and the concern with financial markets is that adjustments happen not gradually, but very rapidly, and in a way that creates turmoil."

He has no prediction as to when. Markets can move unpredictably for years. But Mr. Prasad said, "ultimately a reckoning for both the economy and financial market will come."

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Appeared in the November 20, 2017, print edition as 'Economic and Equities Trends Diverge.'

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